Privy Council Appeal No. 36 of 1989

Commissioner of Inland Revenue *Appellant*

v.

Hang Seng Bank Limited *Respondent*

FROM

THE COURT OF APPEAL OF HONG KONG

JUDGMENT OF THE LORDS OF THE JUDICIAL COMMITTEE OF THE PRIVY COUNCIL, DELIVERED THE 8TH OCTOBER 1990

Present at the hearing:-

LORD BRIDGE OF HARWICH
LORD BRANDON OF OAKBROOK
LORD GRIFFITHS
LORD ACKNER
LORD JAUNCEY OF TULLICHETTLE

*[Delivered by **Lord Bridge of Harwich**]*

The question in this appeal is whether the respondent ("the bank") is liable to profits tax under Part IV of the Inland Revenue Ordinance on profits accruing from the purchase and resale outside Hong Kong of certificates of deposit, bonds and gilt-edged securities in the years 1978 to 1980. The Commissioner of Inland Revenue ("the Commissioner") made and confirmed assessments in respect of those profits for the years of assessment 1978-79, 1979-80 and 1980-81. The bank appealed against the assessments to the Board of Review who allowed the appeal. The Commissioner's appeal to the Court of Appeal of Hong Kong was dismissed. The Commissioner now appeals by leave of the Court of Appeal to Her Majesty in Council.

Section 14 of the Inland Revenue Ordinance provides:-

> "Subject to the provisions of this Ordinance, profits tax shall be charged for each year of assessment at the standard rate on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from such trade, profession or business (excluding profits arising from the sale of capital assets) as ascertained in accordance with this Part."

The bank is a "financial institution" as defined in section 2 of the Ordinance. It carries on business in Hong Kong where it has many branches. In the course of that business it acquires substantial amounts of foreign currencies, in particular United States dollars. The amount of any particular currency which the bank requires to meet its obligations varies from day to day. But at any one time it will hold a substantial surplus available for investment. Before 1978 the bank normally invested its surplus holdings in foreign currencies on fixed deposit with overseas financial institutions. It was never assessed to profits tax on the interest earned by such deposits since the Commissioner accepted that the interest could not be regarded as profits "arising in or derived from Hong Kong".

In 1978 an amendment of the Ordinance changed the law. Section 15(1) opens with the words:-

> "For the purposes of this Ordinance, the sums described in the following paragraphs shall be deemed to be receipts arising in or derived from Hong Kong from a trade, profession or business carried on in Hong Kong."

The 1978 amendment added a new paragraph (i) in the following terms:-

> "(i) sums, not otherwise chargeable to tax under this Part, received by or accrued to a financial institution by way of interest which arises through or from the carrying on by the financial institution of its business in Hong Kong, notwithstanding that the moneys in respect of which the interest is received or accrues are made available outside Hong Kong."

It was no doubt partly in order to minimise its tax liability in view of this change in the law, but it was also, as the Board of Review have found, for good commercial reasons that in 1978 the bank changed its practice. From then on its holdings of foreign currencies were mainly invested in certificates of deposit, and to a lesser extent in bonds and gilt-edged securities. For the purpose of determining the issues in this appeal nothing turns on any distinction between these different forms of security and it will be convenient to confine attention to certificates of deposit. Certificates of deposit are issued by prime banks agreeing to repay a fixed sum of money on a fixed date at a fixed rate of interest but, unlike fixed deposits, are readily marketable at any time before maturity at a price which will fully reflect the anticipation of the interest element accrued up to the date of sale. At the material time there were markets for certificates of deposit in Singapore and London but not in Hong Kong. The bank's practice was for its foreign exchange department continually to monitor its foreign currency holdings and its future foreign

currency requirements and to invest the relevant surpluses in certificates of deposit on the Singapore and London markets at the best rate obtainable and with a view to their resale shortly before maturity to meet obligations which would then arise. Instructions for purchase and sale were given through correspondent banks in Singapore and London. Sales were invariably effected before maturity. The funds used and accruing from these transactions were debited and credited to accounts of the respondent bank with other banks overseas. The profits arising from these transactions are the subject of the appeal.

Before the Board of Review and the Court of Appeal one of the contentions unsuccessfully advanced by the Commissioner was that the profit on resale of certificates of deposit before maturity represented interest on the original purchase price and thus was deemed to be a receipt "arising in or derived from Hong Kong" by virtue of section 15(1)(i), but this contention was not pursued before this Board. The sole issue on which the appeal depends is whether the profits earned by the bank through the buying and selling of certificates of deposit in overseas markets were profits "arising in or derived from Hong Kong" on the true construction of that phrase in section 14.

The primary submission made on behalf of the Commissioner is that the business of the bank is one and indivisible. It is carried on in Hong Kong and all the relevant operations which resulted in the profits in question being earned were directed from Hong Kong and owed their success to the expertise of officers of the bank employed in Hong Kong. No overseas branch of the bank was involved and the funds used in the purchase of certificates of deposit were part of the assets of the bank arising from the carrying on of the bank's business in Hong Kong. For these reasons, it is submitted, the profits accruing from overseas trading in certificates of deposit cannot be looked at in isolation; they are mere components of the profits of an entire business and those profits, as a whole, arise in and derive from Hong Kong.

Their Lordships cannot accept this submission. Three conditions must be satisfied before a charge to tax can arise under section 14:

(1) The taxpayer must carry on a trade, profession or business in Hong Kong;

(2) The profits to be charged must be "from such trade, profession or business", which their Lordships construe to mean from the trade, profession or business carried on by the taxpayer in Hong Kong;

(3) The profits must be "profits arising in or derived from Hong Kong".

Thus the structure of the section presupposes that the profits of a business carried on in Hong Kong may accrue from different sources, some located within Hong Kong, others overseas. The former are taxable, the latter are not. On the Commissioner's submission the requirement of condition (3) would be otiose, since it would be sufficient to show that profits were earned by a business carried on in Hong Kong to make them taxable. Counsel for the Commissioner sought to escape this conclusion by submitting that condition (3) is effective, and is only effective, to exclude from liability to tax the profit earned by what he called a "fully fledged" overseas branch of a Hong Kong bank "which takes in its own deposits, makes its own loans and investments and generally runs its own banking business subject to the overall direction of head office in Hong Kong". Their Lordships cannot accept that the only effect of restricting the scope of profits tax to "profits arising in or derived from Hong Kong" is to exempt a Hong Kong profits taxpayer from liability to tax on the profits of an independent business carried on by him overseas. The Hong Kong taxpayer could in any event secure such exemption for himself, without statutory assistance, by ensuring that the separate business of his overseas branch establishment was carried on by a different company or subsidiary company. To accept the construction which underlies the Commissioner's primary submission would reduce the effect of condition (3) to negligible significance.

It follows that a distinction must fall to be made between profits arising in or derived from Hong Kong ("Hong Kong profits") and profits arising in or derived from a place outside Hong Kong ("offshore profits") according to the nature of the different transactions by which the profits are generated. But here a difficulty at once arises. The net profits of a business before taxation in any given period can only be calculated by deducting from the aggregate income from all sources the aggregate expenses of the business of every kind. If one requires to identify the profits derived from separate transactions, one can only identify the gross profit which each transaction yields. Thus here the gross profit from the bank's trading in certificates of deposit on the Singapore and London markets in any period was the difference between the aggregate of purchase prices paid and of resale prices received less all agents' commission. But this gross profit becomes an item of income in the bank's profit and loss account for the period which, aggregated with all other items of income, only contributes to the net profits when all expenditure has been deducted. The practical problem to which this distinction between gross and net profits gives rise in the calculation of "assessable profits" under section 14, which must of course exclude offshore profits, is resolved by the Inland Revenue Rules made under section 85 of the Ordinance. Rule 2A(1) provides:-

> "No deduction shall be allowed for any outgoing or expense incurred in the production of profits not arising in or derived from Hong Kong, but where any outgoing or expense was incurred partly in the production of profits arising in or derived from within Hong Kong and partly in the production of profits arising or derived from outside Hong Kong then for the purpose of ascertaining the extent to which such outgoing or expense is deductible under section 16 of the Ordinance, an apportionment thereof shall be made on such basis as is most appropriate to the activities of the trade, profession or business concerned."

In this rule the phrase "the production of profits not arising in Hong Kong" is clearly a reference to the gross profits arising from the offshore transactions after deducting from the offshore income only the offshore expenditure specifically referable thereto. But in arriving at the amount of offshore profits to be deducted from the net profit of the business in calculating the "assessable profits" under section 14 it is obviously necessary, as rule 2A(1) provides, that the gross offshore profits should be scaled down to bear their fair share of the general expenses of the business which contributed indirectly to earning Hong Kong and offshore profits alike. This is what was done in the bank's accounts. There is a minor dispute, not pursued in this appeal, as to whether the apportioned share of general expenditure deducted from gross profits of the trading in certificates of deposit was adequate, but such a deduction was made including a proportion of interest paid to depositors in Hong Kong.

The submission for the bank has always been that the source of the income from trading in certificates of deposit, i.e. the gross profits of the trade, was located wholly outside Hong Kong and that the bank was accordingly entitled, subject to adjustment under rule 2A(1), to have those profits excluded from "assessable profits" under section 14. The secondary submission for the Commissioner was and is that, even if the offshore trading transactions must be considered in isolation, the profits they yield arise in or derive from Hong Kong both because the relevant investment decisions are taken in Hong Kong and because the funds used by the bank enabling them to invest overseas in the certificates of deposit derived from their Hong Kong depositors. The Board of Review accepted the bank's submission and rejected that of the Commissioner. Their reasoning appears in the following passages:-

> "The income which is the subject of this appeal is the net difference between the price which the appellant paid for certificates of deposit, bonds and gilt-edged securities and the price which the appellant received when the same were sold. This form of income can only be described as trading

income. It is the profit which arose on the resale of assets which had been previously purchased with a view to such resale.

Having identified the nature or source of the income it is then necessary to locate the source geographically to see whether it arose in Hong Kong or elsewhere. Trading income arises where the activities take place from which the income can be said to arise. On the facts of the present appeal it can easily be seen that the income arose outside of Hong Kong. ...

The moneys used by the bank in purchasing certificates of deposit, bonds and gilt-edged securities came from its customers in Hong Kong but this does not mean that profits arising from the overseas investment of those moneys must likewise derive from Hong Kong. The source of the income which the Commissioner has sought to tax is not the source of the funds invested by the bank but the activities of the bank and the property of the bank from which the profits arose. The moneys received by the bank from its customers were converted into totally different property namely certificates of deposit, bonds and gilt-edged securities. The activities of the bank from which the income arose was the buying and selling of this property in overseas market places and not the decision making process in Hong Kong or any other activities in Hong Kong. Likewise the income arose from the trading in property situate outside of Hong Kong and not the moneys of customers situate in Hong Kong. For us to hold otherwise would mean that a corporation or individual who buys and sells real estate or marketable securities situate in a foreign country would be subject to tax in Hong Kong if it or he were to make the decision so to do in Hong Kong, to base its or his operations in Hong Kong, and use moneys which had once originated in Hong Kong. The Inland Revenue Ordinance does not have any such world wide income concept."

Since appeal from the Board of Review's decision lies on a point of law only, the first question is whether this reasoning betrays any error of law. The Court of Appeal held that it did. The Court of Appeal's reasoning may be summarised in the following propositions:

(1) The assessable profits to which section 14 relates are net profits and it is the source of these net profits which requires to be identified as a Hong Kong source or an offshore source.

(2) The Board of Review erred in law in disregarding the funds acquired in Hong Kong, which the bank

itself had brought into account in its apportionment under rule 2A(1), as one source of the net profits made by the offshore trading. This was, therefore, a "multi-source" case.

(3) Since there is no provision in the Ordinance for apportioning profits as partly Hong Kong profits and partly offshore profits, it is necessary in a multi-source case to identify "a dominant factor or factors which put the profits on one side of the line or the other".

(4) In this case "the balance should tip in favour of an offshore derivation because the profits in question were investment profits and such profits cannot arise until after the investment is made".

Counsel for the Commissioner adopts the Court of Appeal's propositions (1) and (2) but rejects (3) and (4). He submits that once it is established that profits are derived in part from sources within Hong Kong they are either wholly subject to profits tax under section 14 or alternatively there must be an apportionment which would necessitate remission of the case to the Board of Review.

The difficulty their Lordships find in the Court of Appeal's first two propositions is that, like the primary submission made on behalf of the Commissioner, they lead to the conclusion that all the profits of a business which is carried on in Hong Kong (unless derived from a substantially independent branch establishment carrying on a separate business outside Hong Kong) must be regarded as derived in part from sources within Hong Kong. If this then means, as the Commissioner submits, that all profits (except the profits of an independent overseas branch) are taxable, it involves again a construction which gives wholly inadequate content to the phrase "profits arising in or derived from Hong Kong" in the context of section 14. On the other hand, if an apportionment is required, their Lordships are at a loss to discover a rational basis on which it would be appropriate to determine, in a case such as the present, what proportion of the profit derived from the bank's offshore trading in certificates of deposit should be treated as derived from Hong Kong based funds employed in that trading. The Court of Appeal's escape from these difficulties, by seeking "a dominant factor or factors which put the profits on one side of the line or the other", seems to their Lordships to introduce an unacceptably imprecise and elusive test, unless it can be interpreted as a return, by a roundabout route, to the proposition that the source of the profits of individual transactions must be located only by reference to the gross profits accruing from those transactions. But if this is the correct proposition, there was no such error as the Court of Appeal identified in the Board of Review's analysis in the first place.

It appears to their Lordships that rule 2A(1) of the Inland Revenue Rules has been drafted on the assumption that the relevant distinction between "the production of profits arising in or derived from within Hong Kong" and "the production of profits arising or derived from outside Hong Kong" for the purposes of section 14 is a distinction between the gross profits accruing from individual transactions and that the apportionment which the rule then requires of overhead and other general expenditure of the business, which will have contributed indirectly to the earning of profits in both categories, is necessary in order to quantify the share of the net profits of the business which qualify as "assessable profits" under section 14. The rule cannot, of course, determine the construction of the section, but it seems to their Lordships that the rule maker's assumption as to how the section should be construed is correct and indeed that any other construction would lead to an almost insoluble difficulty in distinguishing Hong Kong profits from offshore profits for the purpose of the assessment required to be made by the section.

There remains the argument advanced for the Commissioner that the gross profit from the trading in certificates of deposit arose in or derived from Hong Kong because it was in Hong Kong that the investment decisions were taken on a day to day basis in the exercise of the skill and judgment of officers in the bank's foreign exchange department. Their Lordships think that this argument is authoritatively refuted by the Board's decision in *Commissioner of Income Tax, Bombay Presidency and Aden v. Chunilal B. Mehta of Bombay (Trading as Chunilal Mehta and Company)* (1938) L.R. 65 IA 332. The respondent in that case was a commodity broker carrying on business in Bombay who traded in commodity futures on exchanges in Liverpool, London and New York, giving instructions to buy and sell to brokers operating on those exchanges. The question at issue was whether the profits of the trade were profits "accruing or arising in British India". Beaumont C.J., in the High Court of Bombay, (1935) ILR 59 B.727 posed the question:-

> "Does the fact that profits arising under contracts made abroad depend upon the exercise in Bombay of knowledge, skill and judgment on the part of the assessee, and upon instructions emanating from Bombay, involve that the profits accrued or arose in British India?"

The High Court answered this question in the negative and the answer was duly affirmed by the Board on appeal to His Majesty in Council. This authority can only be distinguished from the instant case if the words in section 14 "derived from" are given a much wider meaning than the words "arising in". Whilst it may be that there is some marginal difference in the shades of meaning conveyed by the two phrases, their

Lordships do not accept that it can possibly be sufficient to bear the weight sought to be put upon it in distinguishing *Mehta's* case.

Their Lordships were referred in the course of the argument to many authorities on different taxing statutes in different common law jurisdictions raising a variety of questions as to the geographical source to which income or profits should be ascribed. But the question whether the gross profit resulting from a particular transaction arose in or derived from one place or another is always in the last analysis a question of fact depending on the nature of the transaction. It is impossible to lay down precise rules of law by which the answer to that question is to be determined. The broad guiding principle, attested by many authorities, is that one looks to see what the taxpayer has done to earn the profit in question. If he has rendered a service or engaged in an activity such as the manufacture of goods, the profit will have arisen or derived from the place where the service was rendered or the profit making activity carried on. But if the profit was earned by the exploitation of property assets as by letting property, lending money or dealing in commodities or securities by buying and reselling at a profit, the profit will have arisen in or derived from the place where the property was let, the money was lent or the contracts of purchase and sale were effected. There may, of course, be cases where the gross profits deriving from an individual transaction will have arisen in or derived from different places. Thus, for example, goods sold outside Hong Kong may have been subject to manufacturing and finishing processes which took place partly in Hong Kong and partly overseas. In such a case the absence of a specific provision for apportionment in the Ordinance would not obviate the necessity to apportion the gross profit on sale as having arisen partly in Hong Kong and partly outside Hong Kong. . But the present case was a straight- forward one where, in their Lordships' judgment, the decision of the Board of Review was fully justified by the primary facts and betrayed no error of law.

Their Lordships have arrived at this conclusion on the basis of the proper construction of section 14 of the Ordinance. But they might have reached the same destination by a very much shorter route. Counsel for the Commissioner had to concede that all the arguments advanced in support of the proposition that the bank's profits from their offshore trade in certificates of deposit arose in and derived from Hong Kong would, if correct, have been equally effective, before the Ordinance was amended in 1978 by the insertion of the new section 15(1)(i), to establish the proposition that the interest received by the bank on offshore fixed deposits up to 1978 was a profit arising in or derived from Hong Kong and that the amendment effected by

section 15(1)(i) was unnecessary to bring that interest into charge to profits tax because the investment decisions relating to fixed deposits were made in Hong Kong and the funds available to be invested were derived from the bank's Hong Kong banking activities. Counsel further conceded that it never occurred to the Commissioner before 1978 that the bank was liable to profits tax on the interest on offshore loans and that the addition to the Ordinance of section 15(1)(i) was made in the belief that it was a necessary amendment to enable the tax to be levied on that interest.

On the basis of these concessions it was put to counsel that section 15(1)(i), which deems the interest on offshore loans made by a financial institution which is "not otherwise chargeable to tax under this Part" to be nevertheless a "receipt arising in or derived from Hong Kong" demonstrated that, without this deeming provision, section 14 could not be construed in such a way as to subject the interest to profits tax and thus refuted the contention that the bank's profit now in question was so subject. To this counsel responded that the legislature cannot by an amendment to existing legislation, which proceeds upon a mistaken belief as to the effect of a provision in the original enactment, alter the meaning of that provision. This is no doubt perfectly correct if the meaning of the original provision is clear and unambiguous, but it is otherwise if there is any ambiguity in the original provision. The principle is clearly stated by Lord Sterndale M.R. in *Cape Brandy Syndicate v. I.R.C.* [1921] 2 K.B. 403, 414 where he said:-

> "I think it is clearly established in *Attorney-General v. Clarkson* [1900] 1 Q.B. 156, that subsequent legislation on the same subject may be looked to in order to see what is the proper construction to be put on an earlier Act where that earlier Act is ambiguous. I quite agree that subsequent legislation, if it proceeds upon an erroneous construction of previous legislation cannot affect that previous legislation; but if there be any ambiguity in the earlier legislation, then the subsequent legislation may fix the proper interpretation which is to be put on the earlier."

This statement has subsequently been referred to with approval on a number of occasions by the House of Lords: see *Ormond Investment Co. Ltd. v. Betts* [1928] A.C. 143, 156; *Kirkness v. John Hudson & Co. Ltd.* [1955] A.C. 696, 711; *Attorney-General v. Prince Ernest Augustus of Hanover* [1957] A.C. 436, 473.

Here the meaning of section 14 is at least ambiguous and it follows that section 15(1)(i) is fatal to the contention that, in the absence of an applicable deeming provision, section 14 is itself effective to bring into tax the profits earned by the bank on the investment overseas of its surplus holdings of foreign

currency whether those profits take the form of interest on fixed deposits or trading profits from buying and selling certificates of deposit. The Ordinance, it is to be noted, has subsequently been further amended to close the loophole left open by section 15(1)(i).

Their Lordships will humbly advise Her Majesty that the appeal should be dismissed. The Commissioner must pay the bank's costs.